

**House Financial Services Committee**

**Capital Markets, Insurance, and Government Sponsored Enterprises  
Subcommittee hearing to examine conflicts in Wall Street research practices**

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## Background: Investars.com

On behalf of the Investars.com team, I am honored to have the opportunity to contribute to these hearings and help restore confidence in Wall Street research.

We founded Investars in the fall of 1999 because we felt that investors needed historical perspective on the stock recommendations issued daily by investment bank analysts. With so many investors new to the market and showing a strong reliance on professional market research, we sought to enable investors to “examine the source” when a recommendation was issued – that is, to provide a means of assessing the investment bank’s track record on the stock in question, on a given sector, and overall.

We developed a ranking system that takes brokerages at their word on stock recommendations, hypothetically investing or withdrawing money on a fixed scale depending on the recommendation type. All recommendations made for a given stock since Jan. 1, 1997 (or shorter time periods selected by the user) are factored into the firm’s rate of return for that stock, and the complete portfolio of a firm’s recommendations is compiled to form its overall Rate of Success Score (ROSS). The information is updated daily. Rankings spotlight investment firms, not individual analysts, tracking the performance of more than 250 institutions on individual stocks, industry sectors, and overall.

In addition to these institutional rankings, our site offers:

- An “IPO Underwriters” feature that compares investment banks’ track records for stocks they have underwritten to their track records for stocks that they have not underwritten.
- Tradeplotter Charts, which graph a firm’s recommendation history on a given stock against that stock’s performance, offering a visual snapshot of the firm’s track record for that stock.
- An Independent Research Ranking system, launching this week, that will connect investors to hitherto unknown small research firms that may have outperformed Wall Street’s large investment banks.

As the name “Investars” indicates, our original intention when the service was conceived at the height of the recent boom was to identify “star” performers on given stocks and in given industries – that is, to help investors determine whose advice to follow. That intention endures. At the same time, the bursting of the tech bubble and subsequent scrutiny of the investment banks’ role in inflating stock prices has thrust upon us a complementary mission: to help the investment community reform itself by providing new vehicles for accountability.

It so happened that by the time Investars.com was ready to launch in May of this year, the ROSS returns highlighted in our investment bank rankings were startlingly poor. As of our 5/29 launch, only four of the 19 banks that had issued recommendations on at least 500 stocks since Jan. 1, 1997 showed positive overall ROSS returns, and only two banks showed returns of over 5% . Complementing this grim overall picture, TradePlotter charts showing single-bank track records on bellwether stocks showed many roads to hell paved with good recommendations – for example, multiple reiterated “buy” recommendations following a stock price slide all the way down from triple digits to single.

Meanwhile, our new users' most frequent query was, "can you incorporate banks' IPO involvement into their track records?" Our ROSS methodology made it relatively simple to track "IPO Underwriter" performance – that is, compile each bank's collective ROSS return for stocks in which it managed or co-managed the IPO, and contrast that return with the bank's score on "Non-IPO" stocks.

On June 12, 2001 we reported that for the banks that had covered at least 500 stocks since Jan. 1, 1997, the average "Return for Stocks Without IPO Relations" was negative 1.08%. But the average "Return for Stocks With IPO Relations" was a startling negative 51.27%. Thus the average "IPO Bias" – the difference between returns on IPO-led and Non-IPO-led stocks – was 50.76%.

### Toward a Market Solution: New Forms of Disclosure

Possible explanations for this manifest "IPO Bias" have been copiously documented in recent months. Rather than reiterate, we will let the data speak for itself – and also point toward a means of reform that requires minimal regulation. Our brief is simple: disclosure is the cure. Mandating a freer flow of information will stimulate a market cure for the real and apparent conflicts of interest that have led to intense scrutiny of analyst practices and deeply shaken investors' confidence in the research issued by brokerages.

If average American investors are to make effective use of research produced by market professionals, they need tools to determine which of these market professionals are worth listening to. Assessment of this kind is possible only if the investment banks fairly disclose the facts. The heavy losses that investors suffered over the last year were aggravated by a system that lacked fair disclosure.

Regulators, investment banks, business information providers, and the media should join together to provide a freer flow of information to all investors, individual as well as institutional. Hindsight has made it clear that the boom-and-bust of the past four years did not leave lasting benefits for any constituency. Investors have suffered, businesses built on unrealistic premises have collapsed, and the brand equity of many brokers whose businesses depend on public trust are being eroded as we speak. We must join forces to implement common sense reforms that will benefit all parties.

Investment banks should:

1. make historical recommendation and earnings estimate data public;
2. fully disclose historical and current investment banking relationships; and
3. adopt a common recommendation language.

### I. Make Public Data Public

The first issue is the distribution of Wall Street recommendation and earnings estimate data. Individual investors suffered in the recent boom-and-bust cycle because they lacked key facts. They lacked these facts because there was and continues to be a monopoly on the distribution of historical data.

Historical data on Wall Street recommendations and earnings estimates is key to being able to analyze track records. However, investment banks are generally unwilling to distribute historical data to individual investors. Many investment banks distribute their historical and current data to a small coterie of companies including Thomson Financial (First Call and IBES) and Multex, with the understanding that the data will only be made available to institutional investors. This system, which enables select companies to control and profit from the distribution of data, does not serve the public. Data distributors should make their money based on value added analysis, not the mere ownership of history.

BulldogResearch.com, one of the first companies to analyze the track records of investment banks, was unable to rank several investment banks due to this data monopoly. Another company that analyzes the track records of investment banks, Another company that analyzes the track records of investment banks, MarketPerform.com, was told By Multex and IBES (a Thomson Financial company) that Multex and IBES have agreements with financial institutions which do not allow them to sell historical earnings and rating changes data to public sites. When Investars.com sought to purchase recommendation data from Thomson Financial, we were told that since we distributed the information to individual investors we could not buy the data.

Validea.com, another services devoted to “analyzing the analysts,” has also suffered from the lack of free information flow. Keith M. Ferry, Validea.com’s President, has stated, "It is quite frustrating and rather confusing that Validea cannot re-distribute Wall Street recommendations to individual investors. Thomson Financial will not allow Validea to license the FirstCall/IBES recommendation data set if the intent is to provide this information to the average investor. We feel the continued unwillingness of the investment banks and data distributors to share this information with investors, along with objective performance statistics, is an injustice and needs to change."

As a first reform, Investars.com proposes that all historical recommendation and earnings estimate data made by investment banks and research firms be made available to all investors. The public stock recommendations of investment banks should be a matter of public record and preserved in a public venue such as an SEC database. Just as companies are required to file 10K forms with the SEC, so should investment banks be required to file their research data with the SEC.

## II. Full Disclosure of Investment Banking Relationships

The second issue that we need to address is the disclosure of investment banking relationships. Investars.com's “IPO Bias” data highlights the fact that investment banks brought to the public markets many companies with questionable business models and recommended that the public buy stock in these companies. The possibility of conflict of interest was not obvious to investors, who lacked the historical data to assess which firms historically have had an IPO Bias and which ones have not.

As a second reform, Investars.com proposes that investment banks disclose to an SEC database their historical underwriting relationship with any company for which they offer research coverage. Important as such disclosure is, however, it is not an end in itself. Disclosure is only raw data. We call on the media, online brokers, financial advisors, research firms and sites such as Investars.com to educate and protect the public by placing this information in context. We are now able to provide far more detail than “bank X upgrades stock Y.” In seconds we can explore an investment bank’s

track record and conduct a detailed peer group analysis. If full disclosure is not contained in the report, we should emphasize the implications of its absence.

### III. Adopt a Common Language

The third issue that we need to address is Wall Street's language. Currently, the average investor needs to know the lingo of more than 200 investment banks and research firms using dozens of different rating scales. Even more disturbing, the language of Wall Street analysts has diverged dramatically from plain English. As Mr. Chuck Hill of Thomson Financial explained in a recent Dow Jones article, "it's widely understood on Wall Street that analysts' recommendations are inflated. For example, to the uninitiated a 'neutral' rating might suggest the analyst is neither favorably nor unfavorably disposed toward a stock... a 'neutral' rating by most investment firms really means 'sell.'" While institutional investors may understand Wall Street's language, individual investors should not need a degree in deconstruction to interpret this "brokerspeak." Investars.com recommends that Wall Street adopt a common rating scale and roll back the grade inflation. Such reforms are simple to implement.

### Conclusion

It is important not to lose site of the beneficiary of these hearings: the average American investor. All investors must be equipped to assess the quality and integrity of professional market analysts. It is common sense – when you buy a car, you check consumer reports. When you buy a house, you have it inspected. A new species of business information providers like Investars.com is creating the tools that give individual investors the ability to analyze the analysts. Although the virtual monopoly on historical data has thwarted the growth of this new industry, new tools have been developed that go a long way toward enabling the public to identify the best and most impartial research on Wall Street.

Research professionals should welcome this new accountability. It is true that our data indicates that in recent years analysts have on average under-performed the market and that analysts are less objective on stocks underwritten by their firms. However, lumped in this "average" are "star" analysts who are the least mentioned victims of the recent carnage. The value of Investars.com lies in helping investors identify the firms that did not allow chaos to cloud objectivity and highlight firms with successful track records.

The so-called "greater fool" market theory states that no matter how much a stock is worth, investors should buy it if they think that there would be a greater fool willing to buy it at a higher price. As long as individual investors don't have the same information as institutional investors, they will forever be the "greater fools" in the market.

In conclusion, we need to have a standard language and facilitate the flow of accurate information. Disclosure will allow the market to make Wall Street accountable. We now possess the technology to refer to an analyst's batting average and provide play-by-play commentary on their ratings. If we can publicize the good and the transparent and flag the foggy and the deficient, heightened investor awareness will enforce industry compliance with higher standards. Market forces will weed out firms who fail to regain public trust.

I am grateful for the opportunity to share our views with you today. Thank you.